

Written Testimony

of

**William L. Davis
Chairman, President and CEO
RR Donnelley**

**before the
U.S. House of Representatives
Committee on Government Reform**

Wednesday, February 11, 2004

EXECUTIVE SUMMARY

RR Donnelley believes in the mission of the U.S. Postal Service and wants to support the changes necessary to ensure its continued health and viability well into the 21st Century. The recommendations as described in our testimony, in order of importance, are as follows:

Maintain Universal Service - The obligation to provide universal service imposed on the USPS, must be maintained for economic and social reasons.

Review of Worksharing – Encourage and incent the USPS to engage in more worksharing to drive productivity like that of major U.S. companies. Ensure that worksharing discounts adequately reflect *all* of the variable costs these activities actually help the USPS avoid.

Review of Upstream Processing Networks – The upstream process is a major contributing factor to many other problems that plague the U.S. postal system. While the entire network should be reviewed, there are savings to be realized in the range of \$6-8 billion if just the upstream process was realigned. The USPS must be given the flexibility to make this an ongoing process.

Productivity Gain – Give the USPS the flexibility and the incentive to implement the programs necessary to post productivity gains similar to those in the private sector.

Ratemaking Process Changes – Create rates that are more predictable, make rates more market driven, and eliminate the “politics” of ratemaking.

Financial Modifications – The USPS should establish a mandate for financial transparency that mailers can rely upon to develop their own business plans.

Enhance The Technology Infrastructure - The USPS should outsource their information systems and information technology to quickly achieve parity with their private sector competitors.

Cultural Transformation – In order for organizational changes of this scope and magnitude to be realized, they must be accompanied by a corresponding transformation.

Governance – The role and make up of the Postal Board of Governors should resemble that of the boards of publicly traded companies.

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Introduction

The United States Postal Service (USPS) is one of the cornerstones of our democracy because of its mission to "bind our nation together through the [distribution of] personal, educational, literary and business correspondence of the people." This has come to be understood by all stakeholders as the mission of providing Universal Service at affordable rates. This timeless goal is 200 years old. In that time, the distribution landscape has changed exponentially. The country has grown; the information and delivery needs of the people have expanded accordingly. Today, an entire mailing industry has evolved to serve the delivery needs of the people based on the USPS' unique ability to provide this distribution whether it takes the form of letters, documents, packages, magazines or consumer goods.

The mailing industry is a key driver of the economy and brings delivery revenues to the Postal Service and its competitors alike. The fact that the mailing industry is a \$900 billion industry employing one in every 15 American workers, is a testament not only to the contributions the industry makes to the U.S. GDP, but to how the people have come to rely on the postal system as a critical path for the flow of hard copy and consumer goods.

Through the services we provide the mailing industry, we are acutely aware of the profound role the USPS plays in the American way of life. We at RR Donnelley believe in the mission of the USPS and want to support the changes necessary to ensure the continued health and viability of the U.S. Postal Service that will enable it to last well into the 21st Century.

What does RR Donnelley need from the USPS? Operationally speaking, RR Donnelley wants to see the same dynamic take hold of the USPS as we see in the private sector – specifically, that over time, quality improves while costs decrease. In the case of the USPS, we would expect this dynamic to take the shape of better service levels at a lower cost.

Improvements in service would take a number of forms – delivery should become faster, with a much more precise delivery window that could make using the USPS as predictable as using some of its private sector competitors. Better service could also be reflected as greater market responsiveness – more quickly and readily addressing new and emerging needs in the market.

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Maintain Universal Service - From RR Donnelley's perspective, there is much about the USPS that is good and should not be changed. It is one of the most recognizable and trusted brands in America and it does a very effective job of delivering information and consumer goods to every household in the nation, six days a week. In so doing, it provides a service that the American people have come to rely on and would be at a loss without.

No competitive model comes close to providing the level of comprehensive coverage to every home that the USPS' "last mile" capability provides. Nor can the competition provide the same level of confidence and security in the mail as the USPS with its controlled access to the mailbox.

We at RR Donnelley believe that it is essential that the USPS preserve these unique capabilities which is, in large part, dependent upon the USPS retaining two key success drivers: Economy of Scope and Economy of Scale.

By maintaining all current Postal products and services provided today (i.e., letters, parcels, periodicals, advertising mail, books, etc.), the USPS is able to provide convenience, privacy and security to the consumer that would not otherwise be feasible. In addition, keeping this expanded product scope enables the second success driver found in the universal service obligation of the USPS to provide access for the American public and businesses to this broad variety of mail products at affordable and regulated prices. We must find ways to encourage first class mail and to continuously focus on improvements to handle parcels, magazines, catalogs and the like. If **any** of these products is eliminated or reduced, the cost for the route carrier gets spread across the others, impacting negatively on their business models.

Protecting the USPS' unrivaled "last mile" infrastructure - including its network of local postal delivery units and its complementary letter carrier franchise - is essential to the USPS' ability to continue to serve the American people. Considering its relevance to our industry and our nation's way of life, RR Donnelley wholeheartedly supports continuation of Universal Service and exclusive USPS control over the mailbox, thereby assuring security and privacy of the mail and the delivery of parcels. This is where the USPS' core competency and key contribution to society lies; therefore, this is what must be preserved.

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Worksharing – Leading companies drive productivity by relentless focus on their core competencies. For everything else, they partner with companies that have complementary strengths. That’s what the USPS needs to do and *worksharing* is the first step toward achieving the productivity demonstrated in the private sector. As it is, the current system does not effectively utilize current capabilities and technologies. Worksharing will solve that problem. It will eliminate redundancies.

Worksharing is not going to happen with the current laws and practices though. The USPS is operating under a set of rules and a business strategy that was established 33 years ago. It’s out of date. It takes too long to get changes through the system.

For example, it took RR Donnelley over 18 months to come to a worksharing arrangement with the USPS for a co-palletization project—and in the end all we got was a three-year “trial” run. In the private sector, we make arrangements like that all the time and they only take several weeks establish.

In addition, the disarray of the price signals set forth in the worksharing program make it impossible for mailers and mail services providers to optimize their own mail preparation functions and logistics networks to take full advantage of the worksharing opportunities that the discounts are intended to provide.

Mailers would like to see prices structured in such a way as to equitably reward mailers for absorbing additional work and bypassing inefficient portions of the postal stream; such inefficient operations (e.g. BMCs) can subsequently be eliminated.

While some may claim that worksharing discounts exceed the savings realized by the USPS, proper measurement and forecasting models have never been developed to assess the impact of different worksharing initiatives on demand. Under the current methodology, worksharing discounts reflect only the variable costs that the USPS avoids when work is done in the private sector, bypassing the USPS function. Moreover, due to complexities in the aforementioned cost accounting system, the worksharing discounts do not adequately reflect *all* of the variable costs these activities actually help the USPS avoid. Even those costs that are measured are not always passed through in the discounts, resulting in an irrational rate structure that is not truly tied to costs.

The problem is, there is no incentive for the USPS to do worksharing. We need new governance rules that not only allow worksharing, but also give the USPS incentives to do more worksharing. Change is essential.

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Retail and Distribution Network Integration – The USPS should always be monitoring and assessing its distribution infrastructure. It is inconceivable to me that adjustments in the USPS network are not ongoing. Facility locations, size, transportation route, all of that should be changing *constantly* to keep pace with demand, to eliminate redundancy and overcapacity, and to achieve productivity gains. *All* businesses need to adjust to changes in customer traffic, demographics or other factors—especially *service* businesses like the USPS. Closing some facilities and consolidating others, outsourcing non-core functions and rightsizing must be done. That’s the kind of flexibility the USPS needs to demonstrate but Congress must give them that kind of flexibility.

Neither upstream processing centers nor the existing retail network should escape examination with respect to performance. The Network Integration Alignment Project (NIA) currently underway within the USPS should be given the high priority status it will need to ensure its success. The NIA is significant because it pursues a charter to create a flexible logistics network that reduces the USPS’ and customers’ costs, increases operational effectiveness, and improves consistency in service.

According to USPS Senior Vice President of Operations, John Rapp, there are a number of significant challenges to the USPS accomplishing the goals of the NIA, including:

- A fixed infrastructure that inhibits the Postal Service's ability to adapt to a changing business environment;
- A disproportionate increase in transportation costs;
- An ad hoc evolution of the distribution network that resulted in non-standard operational procedures;
- Differing and inconsistent preparation and entry exists between mail classes and subclasses;
- Differing and inconsistent service standards also exist; and
- A lack of an integrated information technology solution.

Many of these challenges could be addressed easily through collapsing the existing distribution network and strategically outsourcing upstream processing capabilities to private sector organizations such as RR Donnelley that have a proven track record for handling these processes more efficiently and effectively, and at a lower cost. This shift could generate savings for the USPS somewhere in the range of \$6-8 billion annually.

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Upstream Processing – Today’s “postal stream” is inefficient and obsolete and its structure is a major contributing factor to many other issues that plague the system, from delivery performance to failure to contain costs. According to the USPS’ 2001 Cost and Revenue Analysis, total upstream processing costs in FY 2001 exceeded \$19 billion. This expense represents nearly 30% of the Postal Service’s revenues for FY 2001. A quick examination of the postal stream can shine some light on the operational “Catch 22” surrounding the USPS’ upstream operations.

The upstream postal system consists of three functional layers, each serving an increasingly finer service area than its predecessor. The Bulk Mail Center (BMC) serves the widest geographic area, followed by the Sectional Center Facility (SCF), and then the Destination Delivery Unit (DDU) – or local post office. Current worksharing discounts are set up to encourage mailers to deposit their shipments as far downstream as possible, with the greatest price break being given for mail that is pre-sorted and delivered all the way downstream at the DDU, for “final mile” delivery to the home by a letter carrier. (The letter carrier also serves the mailing public as the “first mile” for correspondence originating from the home.)

For many mailers, DDU insertion provides a very attractive alternative, despite the additional cost that the mailer must incur to sort and transport their product to the “final mile”, and the fact that the postage discounts offered do not adequately reflect the cost savings that the mailer is actually providing the USPS. But as mail volumes move downstream, diseconomies of scale occur within the USPS, and the upstream processing centers become increasingly inefficient. Even as the workforce is diminished through attrition, the capital infrastructure and fixed costs remain a burden to the USPS. The USPS has been largely handicapped when it comes to closing facilities.

The Postal network needs to be collapsed and consolidated. Capabilities should be outsourced where appropriate, allowing inefficient upstream operations to be eliminated whenever possible. It is our belief that these changes will have the following efficiency benefits for the USPS:

- An immediate reduction in operating and labor costs of at least \$6 billion annually;
- improved service performance through the elimination of touch-points;
- greater throughput and efficiencies through the strategic application of automatic sortation technologies; and
- avoidance of billions of dollars annually of ongoing capital expenditure requirements to support upstream infrastructure and additional stranded investments as first class mail volumes decline in the future.

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Productivity Gains

Despite the clear advantages that the USPS' last mile capabilities bring to the American people, there are any number of limitations in its current operating model that do not serve it or its customers well. Despite the significant strides in efficiency that the USPS has made in the last year, it continues to struggle with a number of operational problems, including.

- Failure to achieve productivity increases -- similar to those achieved by private industry -- despite continued capital investments;
- Inability to optimize the upstream distribution network by consolidating and closing obsolete and non-performing facilities and continuing to outsource non-core operations;
- Difficulties in obtaining support for optimizing retail network by experimenting with the number and type of retail facilities providing distribution services;
- Sporadic use of information technology and business data to pinpoint operating inefficiencies and address service issues; and
- Inconsistent operating procedures at Postal facilities because of local management decisions.

A continuous improvement philosophy, penetrating every level of the USPS, is needed to bring about meaningful change – but this critical cultural change is difficult to implement given that the USPS is not incented to maximize profit. This is best seen when you compare productivity gain in the private sector versus the USPS. Since 1970, non-farm businesses have seen a 70% increase in productivity. In that same period, the USPS has seen gains of only 11%.

At the basis of all formal Continuous Improvement strategies, such as the Six Sigma program that has been so successfully implemented at leading companies, including RR Donnelley, there is an underlying “profit motive” that places the need for operational efficiency and customer satisfaction ahead of all others. Without this, the political pull of various factions most impacted by the changes that a Continuous Improvement program entails can derail the focus on operational improvements. A comprehensive Six Sigma program within the USPS would dramatically drive out operating costs, while increasing the reliability and predictability of the mail. We started to implement such programs at RR Donnelley over five years ago. Last year alone, as a result of such initiatives, we drove out costs of nearly \$170 million.

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Ratemaking – The current ratemaking process is costly, cumbersome, political and outmoded. The process, which was adopted as a last minute thought as part of the 1970 legislation, is based on a classic cost-of-service ratemaking. This type of pricing, which was popular back in the 70s, has since been discarded in all other infrastructures, including the telecommunications, electricity and gas industries. According to documents used to support the PRC decision, as much as 35% of the USPS costs which are “fixed” are allocated to users on a non-cost factor basis, which tend to understate demand considerations.

The changes that RR Donnelley would recommend for the ratemaking process focus on creating rates that are more predictable, streamlining the process to make rates more market driven, and on eliminating the “politics” of ratemaking by establishing an effective checks and balances system that sets solid rate limitations and is structured to protect the interests of users of all classes of mail.

First, the mailing industry needs to be able to plan for the impact of the new rate in their postal budgets. Caps should be set for annual rate increases, tying them to the Consumer Price Index, or some other widely accepted leading economic indicator as well as a productivity factor. If rate increases exceed the limitations established through the business rules set forth in the new ratemaking process, then rate requests will be subject to the review of the Postal Regulatory Commission.

Second, the testimonial review process that both the USPS and the Postal Rate Commission (PRC) conduct prior to the implementation of a new rate case is costly and time consuming. The testimonial records can run into the tens of thousands of pages and result in a published decision that exceeds 575 pages. This type of approach is not capable of producing meaningful results, leaving many key issues to be overlooked.

Third, the ratemaking process must be transparent and properly structured from the beginning in order to prevent outside parties from feeling the need to fight a rate increase. A more transparent process would prevent people from tying up the ratemaking process with the endless cycle of testimonies. Individuals would be able to file their concerns with a Postal Regulatory Commission that will be charged with efficiently reviewing and resolving such conflicts.

For example, since the Rate Commission and the Postal Service disagree on key issues regarding cost variability, there are two versions of the Cost and Revenue Analysis produced each year – one that reflects the USPS’ view of cost variability and another, which employs the PRC’s view on how to measure and assess cost variability. The two approaches result in vastly different outcomes.

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To add further complexity to the ratemaking process, if there is a linkage between the Postal Service's operating plan and its rate case projections, the connection is not made clear. In the final analysis, the USPS keeps two sets of books – one for ratemaking and one for budgeting purposes. One activity-based costing method is required to accurately report costs and provide the basis for sound budgeting and rate making.

Finally, in order for this to work however, the Rate Commission should be given greater authority, including subpoena power, to get at the information they need to effectively regulate the ratemaking process.

Financial Modifications - There are a number of financial changes that the mailing industry would like to see which would ensure that the USPS continues to serve its constituents while remaining financially strong. These are focused primarily on improvements in the ratemaking process, but also include certain regulatory changes that would shift how the USPS currently views revenues, efficiencies and continuous improvement, and establish a mandate for financial transparency, which will hold the USPS accountable to the same standards as their larger private sector counterparts.

Our beliefs about the financial changes required of the USPS are founded primarily on the findings of the General Accounting Office (GAO). In a statement made in February, 2002, U.S. Comptroller, David Walker, stated, "We believe the Service's worsening financial condition intensifies the need for...meaningful reform and transformational legislation."

"The 32-year old USPS business model does not work in the 21st century...and will not work," he continued. In a recent report dated January, 2003, the GAO reports on progress toward the improvements it had suggested to the USPS in earlier reports and those set forth in the USPS' own Transformation Plan, conceding that while much progress had been made in the past 12 months, there is still much cause for concern. It also reviewed the Commercial Government Enterprise (CGE) business model proposed in the Transformation Plan as one that would position the USPS to address the future communications needs of the American people. The CGE model is appealing in that it addresses many of the concerns that the mailing industry has with the USPS in its current form. The continued need for a financial mandate for the USPS to break even should also be examined in the context of its new CGE role. We believe this is an essential component of reform. While it was conceived with the best of intentions, it has failed. It distorts the price signal that results from things such as worksharing incentives by causing the USPS to focus on gross revenue rather than profits. If lifted, the USPS would immediately be able to think and act like a business.

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Technology Infrastructure - Better information systems are also critical to the mailing industry for many reasons:

- Electronic filing enables a dramatic reduction of paperwork and eliminates a high percentage of errors;
- Better data enables better performance reporting which is the backbone of any Continuous Improvement initiative;
- Information systems provide greater visibility to the entire Postal stream, enabling the USPS to pinpoint service issues where they start; and
- Greater visibility, in turn, enables the USPS to institutionalize accountability for quantifiable results.

Cultural Transformation – In order for organizational changes of this scope and magnitude to be realized, they must be accompanied by a corresponding cultural transformation. This transformation should focus on three fundamental aspects that currently keep the USPS from becoming a world-class operation:

- An ongoing commitment from Postal employees and management alike to improving efficiency throughout the Postal stream;
- A shift in the USPS culture to become more customer centric and easier to use at all touch-points; and
- An incentive-based organization that rewards productivity and innovation.

Governance

We encourage the Commission to look at the structure, role and make up of the Postal Board of Governors. The Board should be a direct reflection of the size and scale of the USPS and should function just like that of a Board of Directors of a large public corporation. Term lengths and the appointment process should be reviewed. The Board should be composed of individuals, highly qualified to understand the issues confronting USPS, and able to set basic goals and hold management accountable for their realization.

Service Performance Standards - No discussion of opening up the ratemaking process should be undertaken without first taking precautions that rate controls do not come at the expense of declining service performance. In fact, not only should service standards be clearly defined and published, but performance to standards should be publicly reported on as well. Management incentives should be established to ensure that rates are held in check through increased efficiencies.

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The USPS should be required to measure and report on delivery performance for all services it performs as a means of ensuring accountability to U.S. citizens, mailers and users of the Postal Service. Further, with the exception of first class mail, the Postal Service does not consistently or regularly evaluate or publicize performance in relation to guidelines and it is extremely resistant to the use of technology (e.g. CONFIRM) that now exists and that would provide accurate measurement of delivery times for other products, such as bulk business mail or time-sensitive mail classes.

Fortunately, there is precedent for public utilities and quasi-utility enterprises publishing service standards and use, and reporting objective measures of compliance. In all cases, the standards are subject to review (or complaint) by an independent regulator and appropriate sanctions can be assessed for persistent failure to meet standards. We are pleased to see this call for public performance reporting reflected in the GAO's January, 2003, report.

Conclusion

As outlined in its Transformation Plan, the USPS recognizes many changes that can be carried out today, without any changes being made to the current statute; still more positive changes, perfectly legal under the 1970 Act, are outlined in the Mailing Industry Task Force report. Congress should empower the USPS to enact these changes; wherever possible, as quickly as possible.

However, there are many issues that the USPS must also address that do require changes in the current law, such as streamlining the ratemaking process and removing the break-even clause. In order to create an environment that is capable of implementing a successful Continuous Improvement program and making meaningful strides in terms of efficiency improvements, it is clear that the USPS must be unshackled from some of the more limiting aspects of the 1970 Postal Reorganization Act.

Two years ago in The President's 10-Year Budget Plan, President Bush set out a clear mandate for government enterprises to "take lessons from the private sector, finding ways to increase efficiency and customer satisfaction...[make] government more accountable and ultimately [raise] citizen's confidence in the ability of Government to work in partnership with the private sector to raise standards of living for every American." We believe that the USPS must fulfill this mandate by leveraging the capabilities and key learnings of the private sector in order to protect Universal Postal Service for American citizens.

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To accomplish this, Congress must make changes to the 1970 Act that amend the current USPS structure as needed, and to incorporate the best operating practices, incentive systems and technologies used in the private sector that have dramatically changed the face of business over the last 30 years, in order to operate more efficiently and meet the needs of its customers, both large and small.

The USPS should retain its monopoly of letter mail and stay in the parcel business, thus protecting the interests of U.S. citizens. Any new business model for the USPS should allow prices to be more readily flexed to market demand with regulatory limits and rules governing their structure, and a regulatory body at hand to review and settle disputes over rates.

The USPS should also be free to enter into alliances and ventures with related private sector companies that would enable greater system-wide efficiency and outsourcing of non-core operations. In addition to mail processing, the USPS should consider outsourcing their information systems and information technology to more quickly achieve parity with their private sector competitors.

In closing, we would like to commend the USPS on both the Transformation Plan and the progress they have made toward implementing those parts of the Plan that are currently within their power. We are encouraged by the forthright manner in which the USPS and the GAO have identified the issues at hand, and recognize the courage and tough decisions that will be required to build a United States Postal Service best suited for the century ahead.

Finally, we would like to thank the Congress for hearing our testimony, and President Bush for recognizing the need for change in the postal system. We believe that the vision for Government Reform set forth in the 2001 *Blueprint for New Beginnings* provides a solid framework for guiding the Transformation of the United States Postal Service.

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About RR Donnelley

RR Donnelley (www.rrdonnelley.com) prepares, produces and delivers integrated communications across multiple channels for content owners, such as publishers, merchandisers, and telecommunications companies as well as capital markets and diversified financial services companies. As a single source supplying services up and down the communications value chain, the company excels in pre-media, digital photography, content management, printing, online services, and print and package logistics. With these integrated services, RR Donnelley helps customers increase the effectiveness of their targeted communications and distribution strategies. Headquartered in Chicago, Ill., RR Donnelley serves a global customer market and has 31,000 employees in more than 200 locations in North America, South America, Europe and the Asia/Pacific Basin.

About RR Donnelley Logistics

RR Donnelley Logistics, a division of Chicago-based RR Donnelley, provides logistics solutions for a wide range of industries, including leading catalogers, e-retailers, publishers, financial services firms and pharmaceutical companies. As a leader in postal logistics, the company annually directs more than 19 billion print and mail pieces and 160 million packages to homes across the nation. Donnelley Logistics delivers predictable, on-time, cost saving business solutions leveraging its nationwide network of sortation facilities, expedited delivery capabilities and advanced technology systems. For more information about RR Donnelley Logistics, contact the company at www.donnelleylogistics.com

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